

LETTER OF FINDINGS NUMBER: 02-20120260
Adjusted Gross Income Tax
For Tax Years 2004-06

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ISSUE

I. Adjusted Gross Income Tax—Research and Development Credits.

Authority: I.R.C. § 41; Treas. Reg. § 1.41-2; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1.

Taxpayer protests the reduction of claimed research and development credits.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation with operations in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had claimed research and development ("R & D") credits without documentation supporting the claimed amounts of credits on its Indiana adjusted gross income tax ("AGIT") returns for the 2004, 2005, and 2006 tax years. The Department therefore removed those credits from its calculations of Taxpayer's AGIT for those years, which resulted in additional AGIT due for those years. The Department therefore issued proposed assessments for AGIT and interest. Taxpayer protests the removal of the claimed amounts of R & D credits and the resulting assessments. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax—Research and Development Credits.

DISCUSSION

Taxpayer protests the reduction of research and development credits which it claimed on its 2004, 2005, and 2006 Indiana AGIT returns, along with the resulting proposed assessments for additional AGIT for those years. Taxpayer states that the R & D credits were properly claimed. Taxpayer did not have documentation upon which it based its calculations of the credit it claimed. The Department denied Taxpayer's R & D credits in their entirety based on the determination that Taxpayer was unable to substantiate any of the numbers Taxpayer used to calculate the credits. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-1, which in relevant part states:

As used in this chapter:

"Base amount" means base amount (as defined in Section 41(c) of the Internal Revenue Code as in effect on January 1, 2001), modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana in the calculation of the taxpayer's:

- (1) fixed base percentage; and
- (2) average annual gross receipts.

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.

"Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

"Pass through entity" means:

- (1) a corporation that is exempt from the adjusted gross income tax under [IC 6-3-2-2.8](#)(2);
- (2) a partnership;
- (3) a limited liability company; or
- (4) a limited liability partnership.

"Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and payable under [IC 6-3](#).

"Taxpayer" means an individual, a corporation, a limited liability company, a limited liability partnership, a trust, or a partnership that has any tax liability under [IC 6-3](#) (adjusted gross income tax). (Emphasis added).

IC § 6-3.1-4-4 provides:

The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the

allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

"Qualified research" is defined in I.R.C. § 41(d), as follows:

- (1) In general.--The term "qualified research" means research--
 - (A) with respect to which expenditures may be treated as expenses under section 174,
 - (B) which is undertaken for the purpose of discovering information--
 - (i) which is technological in nature, and
 - (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
 - (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).
- (2) Tests to be applied separately to each business component.--For purposes of this subsection--
 - (A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.
 - (B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--
 - (i) held for sale, lease, or license, or
 - (ii) used by the taxpayer in a trade or business of the taxpayer.
 - (C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
- (3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--
 - (A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--
 - (i) a new or improved function,
 - (ii) performance, or
 - (iii) reliability or quality.
 - (B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.
- (4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:
 - (A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.
 - (B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
 - (C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
 - (D) Surveys, studies, etc.--Any--
 - (i) efficiency survey,
 - (ii) activity relating to management function or technique,
 - (iii) market research, testing, or development (including advertising or promotions),
 - (iv) routine data collection, or
 - (v) routine or ordinary testing or inspection for quality control.
 - (E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--
 - (i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
 - (ii) a production process with respect to which the requirements of paragraph (1) are met.
 - (F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
 - (G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.
 - (H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

I.R.C. § 41(b) also provides that:

Qualified research expenses.--For purposes of this section--

- (1) Qualified research expenses.--The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer--
 - (A) in-house research expenses, and
 - (B) contract research expenses.

(2) In-house research expenses.--

(A) In general.--The term "in-house research expenses" means--

- (i) any wages paid or incurred to an employee for qualified services performed by such employee,
- (ii) any amount paid or incurred for supplies used in the conduct of qualified research, and
- (iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property.

(B) Qualified services.--The term "qualified services" means services consisting of--

- (i) engaging in qualified research, or
- (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year.

(C) Supplies.--The term "supplies" means any tangible property other than--

- (i) land or improvements to land, and
- (ii) property of a character subject to the allowance for depreciation.

(D) Wages.--

- (i) In general.--The term "wages" has the meaning given such term by section 3401(a).
- (ii) Self-employed individuals and owner-employees.--In the case of an employee (within the meaning of section 401(c)(1)), the term "wages" includes the earned income (as defined in section 401(c)(2)) of such employee.
- (iii) Exclusion for wages to which work opportunity credit applies.--The term "wages" shall not include any amount taken into account in determining the work opportunity credit under section 51(a). (Emphasis added).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," in relevant part, as follows:

(a) Trade or business requirement--(1) In general. An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase "in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

...

(c) Qualified services--

- (1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).
- (2) Direct supervision. The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.
- (3) Direct support. The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either--
 - (i) Persons engaging in actual conduct of qualified research, or
 - (ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research.
 For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research

laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

...

(d) Wages paid for qualified services--(1) In general. Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(Emphasis added).

The Department denied the credits which Taxpayer claimed, basing its determination on the grounds that Taxpayer did not have any documentation to substantiate the numbers which Taxpayer used in its credit calculations. During the hearing, Taxpayer explained that they did not have any additional documentation ready to provide in support of their claimed credits. Additional time was allowed for the submission of any supporting documentation. Ultimately, no additional supporting documentation was received by the Department on this issue. Therefore, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

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